WSPA
Western States Petroleum Association

NINETY YEARS OF SERVICE
to the Petroleum Industry in the West
1907-1997

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Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P. O. Box 25165, MS 3101
Denver, CO 80225-0165

Re: MMS Proposed Rulemaking - Crude Oil Royalty Valuation

Dear Mr. Guzy:

On behalf of the Western States Petroleum Association (WSPA) and the California Independent Petroleum Association (CIPA), we appreciate the opportunity to provide comments in response to the September 22, 1997 Notice of reopening the public comment period regarding Establishing Oil Value for Royalty Due on Federal Leases and the related discussions occurring at the October 16, 1997 workshop in Bakersfield, California. WSPA is a nonprofit trade association representing companies that explore for, produce, transport, refine and market petroleum and petroleum products in the six western states.

The following is a summary of WSPA's comments. Further details are provided on the following pages.

- WSPA continues to support the retention of the gross proceeds requirement as it was intended, and as is stated in the current regulations, i.e., the gross proceeds accruing to the lessee for production at the lease with existing audit opportunities.

- WSPA continues to support MMS' timely exercise of its option to take its royalty in kind.

- WSPA remains concerned that the MMS has not adequately responded to issues raised in our correspondence dated May 27, 1997 and July 31, 1997, which state that ANS spot prices are fundamentally an unsound starting point for valuation of federal production and that MMS' core assumption (i.e., no market at the lease) is plainly wrong. Although MMS

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has emphasized at the workshops that they seek simplicity and certainty through utilizing ANS spot prices for California, this does not provide fairness to the lessee and satisfy the statutory requirement that royalty be based on the "value of production".

- Some of the proposed alternatives have the potential, if implemented appropriately, to avoid the difficulties posed by valuation based on ANS. As the alternatives were vague and did not provide sufficient detail, continued dialogue will be important to avoid any potential to impose on producers royalty payments that are higher than the range of fair market of the royalty crude.

- WSPA may be able to support MMS revising the existing regulations, which include a series of benchmarks for non-arm's length contracts, instead of replacing it with an indexing scheme. If benchmarks are pursued, it would be important to develop key parameters such as lessee data, limited market areas, screen for comparable quality and quality adjustment.

- Any system that purports to determine accurately the value of California crude oils, as a group, based on ANS pricing alone, will not be valid as an indicator of value. WSPA recommends that MMS abandon any alternative to determine California royalty crude values based on ANS crude oil.

- Use of spot prices is problematic as this method does not account for differences in quality and grade at the lease, there is insufficient volume sold at spot to be representative, and it represents marginal sales.

Continued Concerns With MMS' Proposed Alternatives

WSPA continues to have great difficulty, as previously expressed in our correspondence dated May 27, 1997 and July 31, 1997, with the MMS proposal to calculate California crude oil royalty based on Alaska North Slope spot price less differential to the lease. WSPA has concerns that the MMS proposal abandons the concept of market value at the lease and fails to address the complexities of determining location-quality differentials relative to ANS prices, sulfur penalty, transportation cost allowance, and market differentials, inconsistencies in methodology and application, and index prices that are not representative. Please refer to WSPA's earlier comments submitted to the MMS for a full discussion of these issues.

For California, although ANS crude oil delivered to the West Coast as a crude oil index price is traded in large volumes, it is not necessarily representative of a general trend. Prices in other fields change frequently compounding the problem of determining location-quality differentials reflective of fair market value, creating uncertainty about crude oil values in the producing fields. In order to approximate lease value, quality and location differentials for hundreds of crude oils would have to be calculated on a monthly if not daily basis, and net-back adjustments for a broad range of downstream costs and risks would be required. However, the proposed annual calculation of these differentials could not possibly capture the workings of the market. As discussed at the Bakersfield workshop, quality differentials between ANS and California crudes are large. WSPA believes, based on the comments by MMS at the workshop, that the importance of quality adjustments to any suitable system of estimating crude oil values and their changes with time have been underestimated by MMS.

Many details of the proposals have not been worked out by MMS and consequently the comments on any of these proposals can be only incomplete and any comparison of proposals can be only preliminary at best. Though these comments are directed solely at the issues on which MMS has requested comment, WSPA continues to support the retention of the gross proceeds requirement as it was intended, and as is stated in the current regulations, i.e., the gross proceeds accruing to the lessee for production at the lease with existing audit opportunities. That is, all proceeds received by the lessee in the field of production for crude oil should be used for royalty valuation purposes. WSPA also supports MMS taking its royalty-in-king (RIK) as positive solutions to the overall concerns expressed by MMS. WSPA does not support the MMS current view of gross proceeds which contends that resale proceeds received by an affiliate of a lessee at distant market centers are somehow viewed as gross proceeds accruing to the lessee.

As a point of discussion, WSPA believes that any regulation relating to Oil Royalty Valuation regulation is not applicable for any lease that qualifies for royalty relief. Royalty valuation regulation should not interfere or reduce a lessee's right to obtain royalty relief.The current royalty reduction methodologies and potential future methodologies such as Start of Life Royalty Reduction are crucial to any marginal or unique heavy oil federal leases that exist in California. Loss of the existing and future royalty reduction methodologies would force operators to prematurely abandon leases or surrender leases that are currently not in production. Due to the current ban against additional lease sales offshore California, these leases once surrendered could not be released by the government. This unfortunate result would not only be a waste of valuable natural resources but would also result in significant loss of revenue to the federal government.

Specific Comments on Proposed Alternatives

WSPA offers the following comments on specified alternatives:

WSPA is not commenting on whether any of the alternatives are suitable for the Rocky Mountains or the mid-continent or United States Gulf Coast (USGC) OCS leases. WSPA limits its comments only on issues confronting the West Coast federal oil leases.

(1) Benchmarks

WSPA believes that this development of alternative benchmarks requires further consideration and should be pursued rather than royalty crude valuation based on ANS spot prices. This alternative also has the potential, if implemented appropriately by MMS, to avoid the difficulties inherent in valuation based on ANS.

Benchmark 1 - Sales by the Lessee (Alternative 1)

WSPA believes that this alternative (Bid-out of Tendering) is potentially workable and would be preferable to royalty crude valuation based on ANS crude oil. If implemented appropriately by MMS, this alternative has the potential to avoid the difficulties posed by valuation based on ANS.

Our understanding of this alternative is that a lessee would be allowed to value royalty crude based on the prices that the lessee receives for other crude sold from other leases in the immediate area or region. This alternative may have some merit but many important parameters must be developed before meaningful comments can be prepared.

As a general matter, such a program should be voluntary and it should be available to all lessees.

Benchmark 2 - Purchases by the Lessee (Alternative 2)

Arm's-length purchases of crude oil at the lease also provide unambiguous market data. The comments that would apply to the first benchmark regarding the limited market area, screen for comparable quality and requirement for quality adjustments would also apply to this second benchmark as well. Appropriate adjustments for quality and location, however, would be required.

Benchmark 3 - Third Party Arm's Length Sales (Alternative 2)

Inadequate Data Regarding Benchmark Sales

Given the wide quality variations and other factors inherent in California crude oils, using data points for which all the conditions of sale are not available to the lessee could be a problem. If the lessee is not in a position to be familiar with all the aspects of benchmark sales, the lessee may have inadequate means to defend himself against the use of inappropriate sales as benchmarks.

Benchmark 4 - MMS RIK Prices (Alternative 2)

Benchmark 4, published price by MMS based on RIK sales is not adequately detailed to evaluate at this point.

Benchmark 5 - Market Center Prices (Alternative 2)

Net-backs from market centers would be difficult to determine because there is limited data in California regarding market center pricing. Without knowing what data sources would be used to measure market center pricing, WSPA cannot propose what adjustments need to be made to that data. Probably this benchmark is fatally flawed with respect to the California market.

There is inadequate information to evaluate this Benchmark fully; however, we do note that any movement of the valuation point away from the lease increases complexity and compromises validity of the methodology.

MMS - Calculated Benchmark (Alternative 3)

The third alternative appears to involve creating a pricing index from some type of data system based on surveys by MMS in various, undefined, geogrphic areas. Such a geographic indexing methodology would very likely be unworkable, and values reported and then recorded in an MMS database generally would be obsolete by the time they were published. The marketplace often changes too rapidly, and supply and demand conditions tend to be too localized, for such a database system to work. For example, applying available indices to a large geographic area ignores changing logistical constraints applicable from one field to the next. Thus an increase or decrease in pipeline capacity, refining capacity, or producing volumes, or even changes in the weather, could cause the relevant market factors to differ substantially from those used to develop the applicable geographic index.

(2) Fixed Differentials (Alternative 4)

WSPA believes that any system that purports to determine accurately the value of California crude oils, as a group, based on ANS pricing alone will not be valid as an indicator. As WSPA already has explained, ANS prices and California crude oil prices correlate poorly.

ANS crude oil is more readily influenced by markets outside of California. ANS crude oil is marketed from the Far East to the Midwest. ANS markets respond readily to price influences from all those areas. California crude oils are confined mostly to the state and therefore respond to a narrower set of price influences of which the price of ANS is one.

There are large quality differences between ANS and many California crude oils. California crude oils range from far heavier to somewhat lighter than ANS and many are far more sour than ANS. The differences in values attributable to gravity and sulfur content, themselves are only approximations of the differences in refining values, and cannot be deduced based on ANS price alone. These differences change constantly and

WSPA is unaware of a method that will work satisfactorily. WSPA would be happy to offer comments on the procedures determined by MMS' consultants which were used to prepare earlier workshop materials.

WSPA recommends that MMS abandon efforts to determine California royalty crude values based on ANS crude oil.

(3) Indexing (Alternative 5)

This alternative proposes spot price information. This alternative is problematic as this method does not account for differences in quality and grade at the lease. In addition, there is insufficient volume sold at spot to be representative. Finally, good information is not widely available for California crude prices.

Summary

In closing, WSPA appreciates MMS' willingness to continue dialogue with stakeholders regarding federal crude oil valuation issues. WSPA remains willing to continue discussions to devise a solution to establish the value of crude oil at the lease. Please feel free to contact me for further information or with any questions you may have.

Sincerely,

Catherine H. Reheis